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In the Supreme Court of the United States

OCTOBER TERM, 1948

No. 742

MANUFACTURERS TRUST COMPANY, AS TRUSTEE UNDER AN INDENTURE MADE BY THE DEBTOR UNDER DATE OF SEPTEMBER 27, 1933, AND INDIVIDUALLY, PETITIONER

v.

REGINE BECKER, EMILY K. BECKER, AND WALTER A. FRIBOURG

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE, IN SUPPORT OF THE PETITION

OPINIONS BELOW

The opinion of the court of appeals (C. 8–25)[1] has not yet been reported. The opinion of the district court (A. 116–122) is reported at 80 F. Supp. 822.

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[1] For convenience, we use the same designations to the record as petitioner. "C" refers to part C of the transcript filed in this Court. "A" refers to part A of the transcript, being the appendix to petitioner's brief as appellant below.

JURISDICTION

The judgment of the court of appeals was entered on March 3, 1949 (C. 26). The petition for a writ of certiorari was filed on April 20, 1949. The jurisdiction of this Court is invoked under 28 U. S. C. 1254.

QUESTIONS PRESENTED

1. May a director who has purchased claims against his corporation for a fraction of their face amount during the insolvency of the corporation be permitted to profit thereon in a proceeding under the Bankruptcy Act subsequently initiated by the debtor?

2. Assuming that distribution to a director in the above situation would be limited to cost, does a different rule apply where the purchases were made (a) in the sole discretion of the director acting as agent for his wife and mother, or (b) with the assistance of the director by his office associate?

STATEMENT

In view of the adequacy of the statement in the petition, we omit a separate statement.

ARGUMENT

1. The questions which have arisen here in the context of a Chapter XI proceeding are of importance in the over-all administration of the Bankruptcy Act, and particularly Chapter X thereof in which this Commission has a statutory

interest. The decision below is in conflict with principles which have been applied in other circuits and tends to encourage lax fiduciary standards inconsistent with the basic purpose of the Act.[2]

A major objective of the reforms in reorganization practice embodied in the Chandler Act was to prevent abuses whereby "the financial well-being of investors and the public" was "sacrificed to the insiders' desires for protection and for future profit."[3] In our view fulfillment of this ob-

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[2] The cases cited in notes 4 and 8, *infra*, indicate that the questions involved here have been recurrent in the lower courts, where they have generally been decided contrary to the decision below. At the present time these questions are involved in several Chapter X reorganizations to which this Commission is a party: purchases by a fiduciary during insolvency of the company are involved in *In re Drake Stadium and Field House Corp.*, No. 9758 (S. D. Ia.); family relationships are involved in *In re Equitable Office Building Corp.*, (S. D. N. Y., Jan. 7, 1949), appeal pending in C. A. 2; and in *In re Chicago Rapid Transit Co.*, No. 65,037 (N. D. Ill.); both of these issues are involved in *In re Wade Park Manor Corp.*, No. 64,870 (N. D. Ohio); and in *In re Franklin Building Company*, unreported, No. 25,907 (E. D. Wis., Dec. 23, 1948), appeals pending in C. A. 7.

[3] H. Rep. No. 1409, 75th Cong., 1st Sess., p. 37 (1937). No provision of the Act deals specifically with the consequences of action by officers and directors in breach of their fiduciary duties, but the principle of subordination or limitation of claims is inherent in the powers of a court of bankruptcy as a court of equity. See *Pepper v. Litton*, 308 U. S. 295. Provisions of the Act which do deal with breach of fiduciary relationship in other contexts specifically recognize the appropriateness of the sanction of limitation to cost. *Cf.* Section 212 which expressly authorizes the judge to "limit any

jective requires that fiduciaries be precluded from realizing any profits in a bankruptcy proceeding from transactions which have created a conflict between their self-interest and discharge of their fiduciary obligations. The decision below concedes the application of this principle to purchases by fiduciaries themselves in the course of the reorganization (C. 18–19). We believe that similar considerations apply to purchases during the critical period when a corporation is insolvent, whether or not there has been a determination to resort to bankruptcy proceedings, and also to transactions entered into by close relatives or business associates of a fiduciary with his knowledge and assistance.

2. In our view the occurrence of insolvency, irrespective of the pendency or imminence of the bankruptcy proceeding, creates a sufficient crisis in the corporate affairs to make applicable different rules than are applicable to ordinary corporate operations. Upon insolvency it clearly becomes the duty of the corporation through its directors to consider appropriate measures for

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claim or stock acquired by" a trustee or agent or committee "in contemplation or in the course of the proceeding under this chapter to the actual consideration paid therefor." Similarly, Section 249 provides for disallowance of compensation for services to persons who have traded in securities affected by the reorganization after assuming to act as fiduciaries in a proceeding. Section 249 has been held declaratory of equitable principles which go beyond its express provisions. See *In re Midland United Co.*, 159 F. 2d 340 (C. A. 3).

ehabilitation or for equitable distribution of he corporation's assets among its creditors. Vhether the interests of the corporation and its ecurity holders will best be served by a debt djustment through negotiation or by proceedngs under the Bankruptcy Act or other insolvency statutes should be determined without eference to the self-interest which the securities urchase program of a director would motivate. The self-interest of insiders engaged in a program of purchasing securities of their insolvent orporation may conflict with their fiduciary obigations not only with respect to the character of the disclosures they may make as to the possibilities of salvaging the situation but also with espect to the timing and scope of their salvage efforts, whether by way of informal negotiations vith creditors or by institution of proceedings under the Bankruptcy Act.

These considerations support the rule which has been expressed broadly that purchases by direcors while the corporation is insolvent should be imited to cost. We believe that the court below erred in limiting this rule to the situation where the purchases were actually made during reorganization or where reorganization was in actual contemplation of the directors, as distinguished from the situation where the directors are either endeavoring on behalf of the corporaion to settle with the creditors out of court or nerely considering the possibility of instituting

proceedings under the Bankruptcy Act.[4] Realistically these possibilities will normally overlap and that, in effect, creates the basic problem of conflict of interest.[5]

[4] As pointed out by the majority below (C. 19, n. 11), in some cases enunciating the limitation-to-cost rule for claims purchased by directors during insolvency of the company the purchases were actually made "after some type of bankruptcy proceeding was pending or was imminent and known to be so by the director. *Monroe* v. *Scofield*, 10 Cir., 135 F. 2d 725, 726; *In re Philadelphia & Western Ry. Co.*, 64 F. Supp. 738, 739 (E. D. Pa.); *In re Los Angeles Lumber Products Co.*, 46 F. Supp. 77, 82 (S. D. Calif.)." In these cases, however, the decision was not rested on either of those grounds. Moreover, in other cases enunciating the same rule, the purchases were made a full year prior to the filing of a voluntary petition, *In re The Van Sweringen Co.*, 119 F. 2d 231 (C. A. 6), certiorari denied *sub nom. Terminal & Shaker Heights Realty Co.* v. *Van Sweringen Co.*, 314 U. S. 671, *Gochenour* v. *Cleveland Terminals Building Co.*, 142 F. 2d 991, 992 (C. A. 6), certiorari denied, 323 U. S. 767, and five months before the filing of an involuntary petition, *In re Jersey Materials Co.*, 50 F. Supp. 428 (D. N. J.), and there is no indication in these cases that any judicial proceeding was contemplated by the directors at the time of the purchases. *Cf. In re Norcor Mfg. Co.*, 109 F. 2d 407 (C. A. 7), certiorari denied, 310 U. S. 625, where the purchases were made during a period commencing two and one-half years prior to the filing of an involuntary petition, but during a state court receivership.

[5] We recognize that conflicts of interest in the purchase of debt securities of a corporation by its directors could occur in some situations even where the corporation is solvent, for example, when the directors of a corporation realize that insolvency will necessarily occur in the near future unless measures are taken to adjust its debt. The courts, however, have generally used insolvency as a rule-of-thumb to mark the situation where such potential con-

In our opinion the necessity for limiting to cost the participation of directors on claims acquired during insolvency but prior to the reorganization of the debtor may be even greater than when claims are acquired during the course of the reorganization. During reorganization the debtor and its assets are under the jurisdiction of the bankruptcy court; management decisions are subject to the approval of the bankruptcy court and are made in many cases by an independent trustee; and in most instances the participation of a director in the affairs of the company is of a formal nature. Before reorganization, on the other hand, the director occupies a strategic position, since he actively participates in the management of the corporation, and where the corporation is insolvent his determinations may, as we have shown, greatly affect the interests of the debtor and its security holders.

The court below refused to limit respondents to cost because, *inter alia*, it could not find that the creditors who did not sell to respondents were

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flict cannot be avoided and have generally applied equitable limitations to directors' claims purchased during solvency only where some overreaching or injury to the corporation can be shown, since normally there is no conflict "in the ordinary case of the purchase by a director in a going corporation of its outstanding obligations." *Seymour* v. *Spring Forest Cemetery Association*, 144 N. Y. 333, 344, 39 N. E. 365 (1895); see also *In re Philadelphia & Western Ry. Co.*, 64 F. Supp. 738, 739–740 (E. D. Pa.).

"wronged."* This observation would be equally relevant to purchases during the course of the reorganization, where the court conceded that the limitation to cost doctrine is applicable (C. 18–19), and it emphasizes what we believe is an unduly narrow view of the duty of an equity court to prevent profits from breach of duty. In any event, as pointed out by Chief Judge Learned Hand in his dissent (C. 22):

> * * * if equity regards the bonds as improperly acquired, it is more nearly just to distribute any profits among the other creditors, who have not been paid in full, than to leave them in the director's hands; for they are a part of the bankrupt's assets and the creditors have a better claim to them than the director himself.

Irrespective of whether there may have been "overreaching" with respect to the debenture holders who sold to the respondents, the corporation was wronged when its directors, as its fiduciaries, placed themselves in a position where they

* The majority opinion states (C. 19) that "if a wrong has been done to any of the group of cestuis, it is to those who sold their claims at a price less than the dividend they would have received had they retained them." Yet the sellers, "if they were suing for the wrong done them, * * * would have to show something equivalent to a fraudulent non-disclosure. *Strong* v. *Repide*, 213 U. S. 419." It concludes that if the "unwronged cestuis" are to share in the profit, "it can only be as a disciplinary measure against the director for wronging someone who has not complained of the wrong," a sanction they were unwilling to impose in the absence of overreaching of the sellers.

could not act with an eye single to its interests; hence the directors should not be permitted to profit on a distribution of its assets.[7] Moreover, as a practical matter, the burden of enforcing the insiders' duty of undivided loyalty should not be left solely to security holders who have sold claims to them. The sellers are often not in a position to bring suit, and when they do, as indicated by the court below, they are subject to difficult burdens of proof.

3. The decision of the court below opens new avenues of evasion of equitable limitations applicable to a fiduciary by holding that these limitations do not apply to close relatives or business associates of a fiduciary who act with his knowledge and assistance. This ruling is clearly of substantial importance in the field of bankruptcy and corporate reorganizations.

The majority of the court below held that if equitable principles require the limitation to cost on claims purchased by directors during insolvency irrespective of any overreaching of the sellers, nevertheless proof of overreaching would be necessary in order to apply this limitation to the claims of the wife and mother of a director who acquired the debentures for them, even where these ladies "exercised no independent judgment

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[7] See cases cited in n. 4, *supra*. See also *Bramblet* v. *Commonwealth Land and Lumber Co.*, 26 Ky. L. Rep. 1176, 83 S. W. 599, 602 (1904), and *Pepper* v. *Litton*, 308 U. S. 295, 306–307.

in the investment of their funds" (C. 21). The majority also indicated that in any event the claim of an office associate of directors who apparently was supplied by them with the list of debenture holders, should be allowed in full. The court apparently attributed no significance to the fact that all three claimants had been instrumental in securing control of the debtor by these directors through participation in loans to the debtor at the directors' request (A. 89-90; C. 13).

Concededly, not every associate or relative of a director should necessarily be subject to the same equitable limitations as the director himself. The problem of allowing legitimate transactions by such individuals without inviting circumvention of the limitations upon directors and other fiduciaries can best be worked out on a case-by-case basis. However, the decision below lays down a general rule which requires a showing that the insider's associate or relative "knowingly confederates" in a breach of trust, which is interpreted as something more than acting upon a tip received from the insider. Thus, even where the court below assumed that the insider himself would be limited to cost, the holding is that his relatives and close business associates are free to utilize the insider's special information and advice and assistance in the transaction free of any such disability, at least in the absence of a conventional showing of "overreaching" such as

would warrant a suit for rescission by the seller (C. 21).[8] As such, the decision below may well serve as a precedent for permitting fiduciaries to do indirectly what they may not do directly, and thus has consequences far beyond the immediate problem of trading while the corporation is insolvent and prior to the institution of proceedings.

CONCLUSION

The decision below is inconsistent with the basic policy of the Bankruptcy Act and with the principles applied by other courts of appeals in interpreting the Act; it raises issues of substantial and recurring importance in the field of bankruptcy and corporate reorganizations. The petition for certiorari should be granted.

Respectfully submitted.

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May 1949.

[8] For contrary holdings, see *In re Midland United Co.*, 159 F. 2d 340, 347 (C. A. 3); *In re Midland United Co.*, 64 F. Supp. 399, 416–417 (D. Del.); *In re Equitable Office Building Corporation*, (S. D. N. Y., Jan. 7, 1949); see also *Holman* v. *Ryon*, 56 F. 2d 307, 311 (C. A. D. C.); *In re Inland Gas Corp.*, 73 F. Supp. 785 (E. D. Ky.); *In re Fulton's Will*, 253 App. Div., 494, 2 N. Y. S. 2d 917 (1938); *Gunther* v. *Gove*, 275 Mass. 235, 175 N. E. 464 (1931); *cf. In re Los Angeles Lumber Products Co.*, 37 F. Supp. 708 (S. D. Calif.).

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